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KING IV

INDEPENDENT DIRECTORS

Bolder than ever

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Introduction

The King Committee published the King IV Report on Corporate Governance for South Africa 2016 (King IV) on 1 November 2016. King IV is effective in respect of financial years commencing on or after 1 April 2017. King IV replaces King III in its entirety.

While we acknowledge that most organisations suffer from regulation fatigue, we welcome this new version of the King Code as it not only provides a more practical, principles-based approach to good corporate governance, but also incorporates both global public sentiment and international regulatory change since King III was issued in 2009.

In our view, King IV is bolder than ever before. Firstly, the Code is principles-based and follows an outcomes- rather than rules-based approach. This is in line with current international sentiment which promotes greater accountability and transparency and speaks to the expressed view that the application of the Code should contribute to the performance and health (sustainability) of the organisation. In this regard it is clear that King IV aims to establish a balance between conformance and performance. The Code is further bold in its relentless effort to reinforce corporate governance as a holistic set of arrangements that concerns itself with ethical leadership, attitude, mindset and behaviour. This echoes global developments in the conduct risk arena and also seeks to address and prevent recent examples of corporate failure. Lastly, the boldness of the Code is evident in the clear focus on transparency and targeted disclosures in all areas, specifically in the introduction of far more extensive executive remuneration disclosure than ever seen before. We believe that the recommendations are in line with global developments and perhaps more relevant than ever before in a country where the income differential remains higher than desired.

In this document we specifically discuss the need for and value of independent directors, as well as the King IV approach to the assessment of the independence of directors. It should be noted upfront that each director (regardless of the classification as an executive, non-executive or independent non-executive director) has the duty to always act in the best interests of the company and never to use their position at the company to gain an advantage for either themselves or persons related to them – in order to comply with this duty, each director is required to apply an independent state of mind and objective judgement. Personal interest should never cloud their judgment.

Notwithstanding the fact that each director must act with independence of mind, some directors are classified as 'independent' directors based on the level of their association with or interest in the company. This classification is particularly relevant to ensure a balance of power on the board, and is a key consideration in the composition of the board.

"Independence generally means the exercise of objective, unfettered judgement. When used as the measure by which to judge the appearance of independence, or to categorise a non-executive member of the governing body or its committees as independent, it means the absence of an interest, position, association or relationship which, when judged from the perspective of a reasonable and informed third party, is likely to influence unduly or cause bias in decision-making." **King IV**

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THE VALUE OF *independent* **directors**

One of the key principles in King IV is the establishment of a unitary Board which reflects a balance of power. In order to ensure that no one individual, or group of individuals yield unfettered power on the Board, King IV proposes the appointment of independent non-executive directors.

The value of the inclusion of independent directors on the Board is widely recognised and practised, and can bring a range of benefits to Board decision-making, including:

- adding new skills, knowledge and experience that may not otherwise be available on the Board or within the company, with positive impact on strategy development and oversight;
- bringing an independent and objective view distinct from that of shareholders and management;
- acting as a balancing element in boardroom discussions between different shareholder representatives; managing conflicts of interest affecting Board members;
- safeguarding the interests of minority shareholders and other stakeholders who may not be represented on the Board and who may be unable to speak with a strong voice at shareholder meetings;
- benefiting from their business connections and other contacts;
- undertaking the bulk of the work of Board committees (most Board committees require a majority of independent directors); and
- ultimately, providing reassurance to external shareholders, stakeholders and wider society that the company is being run in an effective manner and in pursuit of its overall mission.

Even though the benefit of the inclusion of independent directors is well recognised, there is a growing concern that the over-emphasis of independence may lead to the under-valuation of industry skill and experience, as some may regard these two concepts as mutually exclusive. However, the composition of Boards is nuanced to ensure not only a balance of power, but also to ensure the inclusion of a diverse group of directors. As such, King IV points out that a balance can only be created if the composition of the Board accounts for a balance of required skills, experience, diversity, independence and knowledge of the company and industry. All of these factors (including independence) collectively yield a balanced Board. The overriding consideration remains whether the Board is composed so that it is able to fully discharge its duties.

All directors, including the independent directors should have a comprehensive understanding of the industry as well as the business of the companies that they serve. It should be noted that the appointment of independent directors in itself does not mean that major shareholders relinquish ultimate control of the Board. A majority vote of shareholders can appoint or remove any director at any time. Major shareholders can ensure that they only approve the appointment of independent directors that share their vision for the company – the involvement of outstanding independent directors can then only enhance boardroom capabilities and the likely success of the enterprise.

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***Practical* implications** OF ASSESSING *independence*

The concept of independence has evolved from the position in King III. Where King III provided a list of disqualifications from independence (i.e. where any of the listed disqualifications applied, a director is regarded as non-independent), King IV takes a more practical approach and rather focuses on the perception of independence.

As such, factual independence or a tick-box approach is replaced by a much more balanced assessment of independence which requires judgment a consideration of substance over form. It is thus possible for someone that meets one of the (King III) disqualification criteria to nevertheless be regarded as independent. It is down to the Board to determine if a director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The yardstick for purposes of this assessment will be the perception of an informed third party, i.e. whether or not an informed outsider regards a director as independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.

As pointed out above, King IV adopts a perceptual approach to independence, i.e. the level of independence of any particular director should be viewed and judged from the perspective of a reasonable and informed third party. The key question to be answered here is whether or not, a director has an interest, position, association or relationship which, when judged from the perspective of a reasonable and informed third party, that is likely to influence unduly or cause bias in decision-making in the best interests of the company.

Although King IV rejects a tick-box approach for the independence assessment, it does provide a list of factors/criteria which may be considered during the independence inquiry, including whether or not a particular director:

- is a significant provider of financial capital, or ongoing funding to the organisation; or is an officer, employee or a representative of such provider of financial capital or funding;
- if the organisation is a company, participates in a share-based incentive scheme offered by the company;
- if the organisation is a company, owns securities in the company the value of which is material to the personal wealth of the director;
- has been in the employ of the organisation as an executive manager during the preceding three financial years, or is a related party to such executive manager;
- has been the designated external auditor responsible for performing the statutory audit for the organisation, or a key member of the audit team of the external audit firm, during the preceding three financial years;
- is a significant or ongoing professional adviser to the organisation, other than as a member of the governing body;
- is a member of the governing body or the executive management of a significant customer of, or supplier to, the organisation;
- is a member of the governing body or the executive management of another organisation which is a related party; or
- is entitled to remuneration contingent on the performance of the organisation.

Comparing independence requirements: the Companies Act, King III and King IV

Companies Act - Independent if:

- The director was not involved in the day-to-day management of the business for the previous financial year.
- The director was not a full time employee or prescribed officer of the company or a related company during the previous three financial years.
- The director is not a material supplier or customer of the company such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship.
- The director is not related to anybody who falls within the above criteria.

King III - Independent if:

- The director is not a representative of a shareholder who has the ability to control or significantly influence management or the Board.
- The director does not have a direct or indirect interest in the company (including any parent or subsidiary in a consolidated group with the company) which exceeds 5% of the group's total number of shares in issue.
- The director does not have a direct or indirect interest in the company which is less than 5% of the group's total number of shares in issue, but is material to his personal wealth.
- The director is not a professional adviser to the company or the group, other than as a director.
- The director has not been employed by the company or the group of which it currently forms part in any executive capacity, or appointed as the designated auditor or partner in the group's external audit firm, or senior legal adviser for the preceding three financial years.
- The director is not a member of the immediate family of an individual who is, or has during the preceding three financial years, been employed by the company or the group in an executive capacity.
- The director is free from any business or other relationship (contractual or statutory), which could be seen by an objective outsider to interfere materially with the individual's capacity to act in an independent manner, such as being a director of a material customer of or supplier to the company.
- The director does not receive remuneration contingent upon the performance of the company.

King IV - Independent if an informed third party perceives the director as independent:

The Board should consider the following and other indicators holistically, and on a substance-over-form basis, when assessing the independence of a member of the governing body for purposes of categorisation: The director:

- is a significant provider of financial capital, or ongoing funding to the organisation; or is an officer, employee or a representative of such provider of financial capital or funding;
- if the organisation is a company, participates in a share-based incentive scheme offered by the company;
- if the organisation is a company, owns securities in the company the value of which is material to the personal wealth of the director;
- has been in the employ of the organisation as an executive manager during the preceding three financial years, or is a related party to such executive manager;
- has been the designated external auditor responsible for performing the statutory audit for the organisation, or a key member of the audit team of the external audit firm, during the preceding three financial years;
- is a significant or ongoing professional adviser to the organisation, other than as a member of the governing body;
- is a member of the governing body or the executive management of a significant customer of, or supplier to, the organisation;
- is a member of the governing body or the executive management of another organisation which is a related party; or
- is entitled to remuneration contingent on the performance of the organisation.

The Board should always consider the independence of a director from the perspective of a reasonable and informed third party.

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INTERNATIONAL *trends*

With respect to both the emphasis of the importance of including independent directors on the Board as well as the approach to classifying a director as independent, King IV seems to be in line with international best practice.

When comparing King IV to some of the most influential international corporate governance codes (such as the International Corporate Governance Network's *Global Governance Principles*, the New York Stock Exchange's *Listed Company Manual*, the Australian *Corporate Governance Principles and Recommendations*, the *UK Corporate Governance Code*, the OECD *Principles of Corporate Governance*, and the Canadian *Corporate Governance Guidelines*) we see that King IV reflects international trends.

As is the case in King IV, all of these international codes propose that the majority of the members of the Board should be independent. As is the case in King IV, most of the international codes require the Board to determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. Another common feature in the aforementioned international codes is the emphasis on transparency – the Board is required to disclose their reasons for classifying a director as independent.

More often than not the codes make it clear that independence is a matter of perception, and not a matter of fact, and proceed to provide a list of criteria which the Board should consider when considering independence.

five QUESTIONS FOR *directors to ask*

01

What is the ratio between independent and non-independent directors on the Board?

02

Is the Board able to explain and justify their decision for classifying a particular director as independent?

03

Can the Board provide clear reasons for their decision to classify a director as independent where one or more of the criteria which may indicate a lack of independence applies to this director?

04

Are there independent directors who have served on the Board for more than nine years? If so, did the Board assess the continued independence of these directors and disclose the details of the assessment and findings in this regard?

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Conclusion

The value of appointing independent directors to the Board should not be underestimated. These directors have a crucial role to not only act as a sounding board to the executive and to elevate the level and quality of Board discussions by adding additional, independent perspectives, but they also act as custodians of the rights of shareholders (including minority shareholders) and stakeholders.

The onus of classifying directors as independent rests with the Board. The adoption of the approach to apply perceptual, rather than factual, independence is welcomed. We support the move away from a tick-box approach to a more practical approach. However, this new approach places a heavy burden on Boards in that they need to ensure they are able to explain and justify their decisions to classify directors as independent.

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